Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Gallegos	Analyst:	Gloria McConnell	Bill Number:	AB 726
Related Bills:	AB 1061	Telephone:	845-4336	Introduced Date:	02/24/99
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SUBJECT: Health Care Service Plan Through Nonprofit Purchasing Coalition Credit

SUMMARY

This bill, as it directly impacts the FTB, would allow a credit equal to 25% of the amount paid or incurred by a taxpayer during the taxable year to participate in a health care service plan offered by his or her employer through a nonprofit purchasing coalition.

The credit could be claimed only if the federal government allows a tax credit for small employers that provide health coverage for their employees through a nonprofit purchasing coalition.

This bill also would make changes to certain California health insurance laws. This analysis discusses only those provisions that would impact the department's programs.

EFFECTIVE DATE

This bill would be effective January 1, 2000, but the tax credit would be operative for taxable years beginning on or after January 1, 1999, and before January 1, 2004.

PROGRAM HISTORY/BACKGROUND

According to Excerpts from President Clinton's Fiscal Year 2000 Budget Submitted to Congress Feb. 1, 1999, " Small businesses generally face higher costs than do larger employers in setting up and operating health plans in the current insurance market. Health benefit purchasing coalitions provide an opportunity for small businesses to purchase health insurance for their workers at reduced cost and to offer a greater choice of health plans. However, the formation of health benefit purchasing coalitions has been hindered by their limited access to capital. To facilitate the formation of these coalitions, the Administration proposes to establish a temporary, special rule that would facilitate private foundation grants and loans to fund the initial operating expenses of qualified health benefit purchasing coalitions (i.e., those certified by a federal or state agency as meeting specified criteria) by treating such grants and loans as made for exclusively charitable purposes. In addition, to encourage use of qualified health benefits purchasing coalitions by small businesses, the Administration proposes a temporary tax credit for qualifying small employers that currently do not provide health insurance to their workforce. The credit would be equal to 10% of employer contributions to employee health plans purchased through a qualified coalition.

Board Position:			Department Director	Date
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The maximum credit amount would be $200 per year for individual coverage and $500 per year for family coverage (to be reduced proportionately if coverage is provided for less than 12 months during the employer's taxable year). The credit would be allowed to a qualifying small employer only with respect to contributions made during the first 24 months that the employer purchases health insurance through a qualified coalition, and would be subject to the overall limitations of the general business credit. The proposal would be effective for taxable years beginning after December 31, 1999, for health plans established before January 1, 2004. The special foundation rule would apply to grants and loans made prior to January 1, 2004, for initial operating expenses incurred prior to January 1, 2006." An administration official further indicated the proposed tax credit would be for businesses with between 2 and 50 employees and that did not provide health insurance in 1997 or 1998.

According to California's Managed Risk Medical Insurance Board (MRMIB), it administers a state small employer purchasing pool. Over 140,000 Californians and 7,400 businesses participate in the Health Insurance Plan of California (HIPC). MRMIB staff assumes that HIPC would not be considered a "nonprofit purchasing coalition" because it is state managed. In addition, MRMIB staff indicates it is unclear whether any "nonprofit purchasing coalitions" currently operate in California. According to an April 6, 1999, press release, the Pacific Business Group on Health (PBGH) won a competitive bidding process to manage HIPC. PBGH is expected to assume full responsibility July 1, 1999, for this small employer purchasing pool. PBGH is described as a "nonprofit business health coalition."

SPECIFIC FINDINGS

Under state and federal law, taxpayers who itemize their deductions are able to deduct medical expense costs, but the deductions are limited to amounts which exceed 7.5% of adjusted gross income. This threshold cannot be met by most taxpayers unless they have very high medical expenses. "Medical care," as defined under Internal Revenue Code (IRC) Section 213, generally means amounts paid for

- The diagnosis, cure, mitigation , treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body,
- Transportation primarily for and essential to medical care,
- Qualified long-term care services, or
- Insurance covering medical care or for any long term care insurance contract.

Existing state and federal law allow businesses to deduct expenses paid or incurred in the ordinary course of business (e.g., an employee's health care coverage). Employer-provided health care coverage is not includible in the taxpayer's income.

Under federal and state law, taxpayers with high deductible employer-provided health plans who make contributions to medical savings accounts (MSAs) are allowed to deduct a certain percent of the annual deductible under the coverage. Withdrawals from MSAs for qualified medical care (as defined under IRC Section 213) are not taxable to the taxpayer, and employer MSA contributions are not includible in the taxpayer's gross income.

This bill would provide a credit equal to 25% of qualified expenses paid or incurred by a taxpayer during the taxable year to participate in a health care service plan offered by an employer of the taxpayer through a nonprofit purchasing coalition.

"Qualified expenses" would mean amounts paid or incurred for any premium, deductible, copayment, or other out-of-pocket costs to participate in a health care service plan offered by an employer of a taxpayer through a nonprofit purchasing coalition.

The credit could be claimed only if the federal government allows a tax credit for small employers that provide health coverage for their employees through a nonprofit purchasing coalition.

The credit, the excess of which may be carried over to succeeding years, would be in lieu of any deduction for the expenses for which a credit is claimed pursuant to this bill.

Policy Considerations

- The credit is operational on the condition that a loosely identified federal tax credit is enacted. However, the proposed federal tax credit could be significantly changed as it moves through the federal legislative process or may not be enacted until late in California's legislative process. Therefore, it may be premature to allow a state tax credit before the targeted federal tax credit is enacted and subject to evaluation by the Legislature. Moreover, it is unclear whether the proposed federal credit must be in effect for **each** year for which the credit under this bill would be allowed, or only for a single year during the five taxable years this credit would be operative under this bill.

- Because the bill provides that any credit taken for this section would be in lieu of any deduction for those expenses, if a taxpayer itemizes deductions for federal purposes but takes the credit under this bill for state purposes, the taxpayer would have to make an adjustment in computing state itemized deductions on Schedule CA. This adds complexity to tax return preparation.

- The employer federal tax credit currently being proposed and discussed at the federal level would be limited to a two-year period per employer, to employers with two to fewer than 50 employees, and to employers that have not provided insurance in 1997 and 1998. Though the operation of this bill's credit is conditioned on the enactment of this loosely identified federal credit, the tax credit is not conditioned on the taxpayer's employer being allowed the federal credit for the same year that the taxpayer paid or incurred the expenses. It is unclear if that is the intent. For example, without clarification, the employer could have taken the federal credit for the allowable two years, but the employee could continue to claim the credit provided under this bill beyond the two-year period; the taxpayer could be self-employed or his or her employer could employ more than 50 people and not qualify for the federal credit; or employers could switch their employees' existing coverage to a plan offered through a nonprofit purchasing coalition, and the employee could take the credit under this bill for qualified expenses.

Implementation Considerations

- To avoid confusion for employers and staff, “nonprofit purchasing coalition” should be defined, and when such coverage is purchased, the bill should require that employers be provided with a certification of that fact, which they can pass on to their employees. In addition, the federal law that is being targeted should be more clearly identified.

- It is unclear whether the cost of prescription medication, the copayment relating to prescription medication or out-of-pocket car expenses would be included as a “qualified expense” for purposes of this bill. These amounts are a deductible medical expense for purposes of itemized deductions, but may not be considered “costs to participate in a health care service plan.” If car expenses are a qualified expense under the bill, it is unclear whether the cost would be limited to out-of-pocket expenses or whether the taxpayer would be required to use the 10 cents per mile standard rate for medical expenses allowable as an itemized deduction.

- This bill would provide an unlimited carryover of excess credit amounts. Since tax credits are usually used within eight years, most recently enacted credits contain limited carryover provisions, usually eight to ten years.

- To reduce compliance complexities, FTB should be able to readily verify that the taxpayer’s employer did purchase the required insurance. It is suggested that the employer be required to certify to the taxpayer at the time the coverage is provided that coverage is through a nonprofit purchasing coalition. The taxpayer would then provide the certification to FTB upon request.

- Conceivably, the federal provision on which this tax credit is conditioned could be enacted late this year or early next year. Generally, the department completes the development of forms and instructions for tax returns for a given year by October, at which time the designs are sent to the state printing office. This timing is integral in meeting the department's goals of providing forms and instructions to taxpayers no later than the following January. If the federal law for which this tax credit is conditioned is not enacted or clearly defeated by August or September, FTB staff would not know with certainty whether to develop forms and instructions to include this bill's tax credit. This uncertainty could also affect the annual update of the department's computer systems, which are updated immediately after bills are enacted into law to provide enough time to complete and thoroughly test the program changes before any tax returns are filed.

  As an alternative to specifying a date this year that the federal law must be enacted, the credit could be operative for taxable years beginning on or after January 1, 2000.

FISCAL IMPACT

Departmental Costs

The department's costs to administer this bill cannot be determined until the implementation considerations have been resolved.

Tax Revenue Estimate

The estimated revenue impact of this bill is shown in the following table:

Revenue Impact of AB 726 as Introduced February 24, 1999 Effective 1/1/99, Assumed Enacted After 6/30/99 ($ Millions)		
1999-0	2000-1	2001-2
$ (0)	$ (6)	$ (12)

This analysis does not take into account any change in employment, personal income, or gross state product that may result from this bill becoming law.

Tax Revenue Discussion

The revenue impact of this bill would be determined by health insurance costs incurred by employees of certain employers and the tax liability of those employees.

This bill is conditioned on federal law changes that are not yet defined, but are conceptually described in "Excerpts from President Clinton's Fiscal 2000 Budget Submitted to Congress February 1, 1999." This estimate takes into consideration that conceptually described tax credit; however, this estimate assumes that because of other provisions in this bill that the taxpayer generally would be an employee of an employer with 100 or fewer employees. Additionally, this estimate assumes that based on the federal credit, the tax credit under this bill would apply only if the employer had not previously provided health insurance to employees. Furthermore, because of the special rules to facilitate the funding of these coalitions under the President's proposed budget, this analysis assumes qualified coalitions would emerge in California in the year 2000, not before.

This estimate was prepared as follows: First, the number of employees in firms of 100 or fewer workers was estimated from EDD data to be 7.3 million for 1999. This number was grown by 2.5% annually for the out years. Second, the number of employees in this group who are not insured through employer provided health insurance was estimated to be 2.8 million for 1999 from "Pension and Health Benefits of American Workers", U.S. Department of Labor, May 1994. Third, the response of employers to the federal incentives was estimated to be such that the percentage of currently uninsured who would become insured as a result of the federal tax incentives would be 0% (1999), 2% (2000), 4% (2001), 6% (2002), and 8% (2003).

Fourth, it was estimated that the average individual would spend $400 per year for his or her share of health insurance premiums and would thus qualify for a credit of $100. Finally, it was assumed that all the credit would be used on the return filed for the year in which the credit was created.

BOARD POSITION

Pending.